IN THE

# Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1334

W & W FERTILIZER CORPORATION,
*Petitioner*

*v.*

THE UNITED STATES OF AMERICA,
*Respondent*

# PETITION FOR A WRIT OF CERTIORARI
## TO THE UNITED STATES COURT OF CLAIMS

Sherwin P. Simmons
Trenam, Simmons, Kemker,
Scharf & Barkin
2600 First Financial Tower
Tampa, Florida 33601

*Counsel for Petitioner*

# INDEX

## CITATIONS



### STATUTES



### REGULATIONS





### REVENUE RULINGS

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1975

---

No.

---

W & W FERTILIZER CORPORATION,
*Petitioner*

*v.*

THE UNITED STATES OF AMERICA,
*Respondent*

---

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

---

The Petitioner, W & W Fertilizer Corporation, respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of The United States Court of Claims entered in this proceeding on December 17, 1975. References are to the Appendix included as a part of this Petition.

### OPINION BELOW

The opinion of The United States Court of Claims, Docket No. 17-74, has not yet been officially reported. An unofficial report is found at 76-1 USTC ¶9130. A copy of the opinion is appended to this petition as Appendix A.

### JURISDICTION

The judgment of The United States Court of Claims was

made and entered on December 17, 1975. This Petition for Writ of Certiorari was filed within ninety (90) days of that date. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255(1).

## QUESTION PRESENTED

Where an individual establishes a revocable inter vivos trust, retaining all ownership rights therein, both in fact and in law, and transfers to that trust stock of an electing "small business corporation", will the stock in said corporation in the hands of the trust be deemed to be held by a person other than the individual, so as to result in a termination of the corporation's election pursuant to Section 1372 of the Internal Revenue Code.

## STATUTORY PROVISIONS AND REGULATIONS INVOLVED

The question presented in these proceedings involves Sections 1371(a) and 1372(e)(3) of the Internal Revenue Code of 1954 (26 U.S.C. 1371(a), 1372(e)(3)) and Treasury Regulations, Sections 1.1371-1(d)(1), 1.1371-1(e) and 1.1372-4(b)(3) (26 CFR 1.1371-1(d)(1), 1.1371-1(e), 1.1372-4(b)(3)). These statutory provisions and regulations are set forth in Appendix B hereto.

## STATEMENT OF THE CASE

This is a suit arising under the Internal Revenue Code of 1954 (hereinafter referred to as the "Internal Revenue Code"). The facts involved are as follows:

The Petitioner was incorporated under the laws of the State of Florida on March 20, 1907. On or about April 27, 1965, the Petitioner elected to be taxed as a "small business corporation" pursuant to Section 1371 et. seq. of the Internal Revenue Code (hereinafter referred to as "Subchapter S"). The election was effective for Petitioner's taxable year ending March 31, 1966, and subsequent years.



At the time of making the election, the Petitioner had only two shareholders: Lemuel P. Woods, owning 1,415 shares (46.6% of the total outstanding); and, Fred J. Woods, his brother, owning 1,624 shares (53.4% of the total outstanding), both of whom consented to the election.

On February 25, 1970, Lemuel P. Woods established the Lemuel P. Woods Revocable Trust (hereinafter referred to as the "Woods Trust"). Among the assets transferred to the Woods Trust on that date were all of the shares of stock in the Petitioner owned by Lemuel P. Woods.

The Woods Trust was a revocable inter vivos trust, all of the income of which was taxable to and reported for federal income tax purposes by Lemuel Woods. Lemuel Woods reserved to himself the right to revoke the Woods Trust at any time and to revest title to the assets held by the Woods Trust in himself. The Exchange National Bank of Tampa (hereinafter referred to as the "Exchange Bank") was designated a co-trustee, along with Julia Woods, Lemuel Woods' wife (hereinafter referred to as "Mrs. Woods"), who was designated a co-trustee for the sole purpose of consulting with the Exchange Bank with respect to the investment of trust assets.

Prior to the establishment of the Woods Trust, Lemuel Woods had been advised and assured by the Exchange Bank that he would retain absolute control during his lifetime over all assets transferred to the Woods Trust.

Lemuel Woods was the sole income beneficiary of the Woods Trust. The Trustees have never made any income distribution or payment from the Woods Trust except as directed by Lemuel Woods.

At the time of the establishment of the Woods Trust, Fred J. Woods, brother of Mr. Woods, and members of his family owned 278,416 shares, or 6.8%, of the outstanding stock of the Exchange Bank Corporation, the bank holding company which wholly owned the Exchange Bank. The shares owned by the

Woods family constituted the third largest block of common stock owned by any single family. In addition, Fred J. Woods was Chairman of the Board of Directors of both the Exchange Bank Corporation and the Exchange Bank. He was also President of the Exchange Bank Corporation and had served as a Director of the Exchange Bank since January 10, 1939.

The Woods family was one of the three most influential families in the affairs of the Exchange Bank, and one or more members of the Woods family were in contact with officers of the Exchange Bank on a daily basis. The officers of the Exchange Bank, including the officers responsible for the administration of the Woods Trust, courted the favor of the members of the Woods family and accorded them preferential treatment in all their dealings with the Exchange Bank, including the administration of the Woods Trust.

The Exchange Bank did not make any investment or other substantive decision with respect to the administration of the Woods Trust without first consulting with and obtaining the approval of Lemuel Woods. The Exchange Bank promptly, unquestioningly, and faithfully executed any and all instructions issued by Lemuel Woods with respect to the administration of the Woods Trust.

As a result, Mr. Woods at all times retained and exercised absolute control over the assets composing the Woods Trust, including the stock in Petitioner.

The Petitioner timely filed its tax return for the taxable year ended March 31, 1970 on Form 1120-S. Subsequently, on or about April 13, 1971, an amended corporate income tax return, Form 1120-X, accompanied by an amended Form 1120, was filed by the Petitioner with respect to the same taxable year.

The Form 1120-X and the amended Form 1120 with respect to the taxable year ended March 31, 1970, were prepared and filed on the basis that the Subchapter S election of the Petitioner



had terminated, resulting in a corporate income tax liability for that taxable year. The tax was paid on or about April 15, 1971, and interest thereon was paid in two later installments.

The amended returns were accompanied by a cover letter stating that their filing and the payment of additional taxes in connection therewith did not constitute and should not be deemed to constitute an admission by the Petitioner of a termination of its Subchapter S election.

On April 13, 1973, Petitioner filed a claim for refund in which it alleged, and has maintained ever since, that the Woods Trust was a nullity under applicable principles of taxation and that the Petitioner had at no time a shareholder other than an individual. On January 17, 1974, the claim for refund was officially disallowed in full.

On January 11, 1974, Petitioner brought suit in The United States Court of Claims, Washington, D.C., pursuant to 28 U.S.C., Section 1491. Following filing of joint motions for summary judgment, presentation of briefs and oral argument, the Court granted Respondent's motion for summary judgment, denied Petitioner's cross motion for summary judgment, and dismissed the Petition.

## REASONS FOR GRANTING THE WRIT

The United States Court of Claims has decided a question of major significance regarding the ability of small businessmen to select a form of business organization without the necessity of taking into account major differences in federal income tax consequences. In reaching its decision, the Court of Claims repudiated traditional principles of federal tax law and adopted positions inconsistent and in conflict with decisions both of this Court and other courts and rulings of the Internal Revenue Service.

In particular, the decision below should be reviewed for the following reasons:

1. The decision provides that the doctrine of substance over form and the traditional principles of federal taxation respecting trusts, forcibly enunciated by this Court in *Helvering v. Clifford*, 309 U.S. 331 (1940), are inapplicable in determining who is a shareholder in a Subchapter S corporation.

2. The decision provides that a revocable inter vivos trust is to be accorded a treatment in the context of Subchapter S which is different from that accorded such a trust in other areas of the Internal Revenue Code.

3. The decision is in conflict with decisions of this Court and other federal courts and the rulings of the Internal Revenue Service.

In 1958, Congress enacted Subchapter S of the Internal Revenue Code for the purpose of affording tax relief to small businesses by eliminating federal income tax consequences as a factor in the selection of forms of business organization. With few exceptions, Congress designed Subchapter S to make the same tax treatment previously available only to proprietorships and partnerships also available to those small corporate business structures economically similar to proprietorships and partnerships. To this end, Subchapter S provides a qualified "small business corporation" the option of eliminating federal income tax at the corporate level, thereby avoiding double taxation of business income.

To restrict the availability of the relief afforded by Subchapter S, Congress provided that a qualifying "small business corporation" may not ". . . have as a shareholder a person (other than an estate) who is not an individual; . . .". The question before the Court of Claims in this proceeding was whether the Woods Trust was for federal income tax purposes an entity separate and distinct from its grantor so that for purposes of Section 1371(a) of the Internal Revenue Code the Woods Trust and not Lemuel Woods was the shareholder in Petitioner.



**Renunciation of Substance over Form and Other Traditional Doctrines**

In determining whether Lemuel Woods or the Woods Trust should be treated as the shareholder of Petitioner for Subchapter S purposes, the Court of Claims declined to employ the doctrine of substance over form and other traditional analytic principles. Instead, it focused on the admitted, but inapposite, fact that the Woods Trust was a viable legal entity under the laws of the State of Florida, and ignored that under state law and the terms of the trust agreement Lemuel Woods was the beneficial owner of the trust assets.

The Court of Claims failed to recognize that although a trust may exist for state law purposes, that fact is irrelevant to a determination whether its existence will be recognized for federal income tax purposes. *Irvine K. Furman*, 45 T.C. 360 (1966), *aff'd per curiam*, 381 F.2d 22 (5th Cir. 1967). As pointed out by this Court in *Helvering v. Clifford*, *supra*, whether a trust is to be recognized as an entity for federal income tax purposes depends on the nature and degree of control over the trust assets and their administration retained by the grantor. As stated by this Court therein:

> "Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which invented genius may construct as a refuge from surtaxes should not obscure the basic issue. *That issue is whether the grantor after the trust has been established may still be treated . . . as the owner of the corpus. . .*" (Emphasis Added) 309 U.S. at 334-335.

The erroneous preoccupation of the Court of Claims with the admitted existence of the trust for state law purposes was central to its decision and led it to disregard traditional principles of federal tax law in resolving the question before it. An application of these principles to the facts of this case compel the conclusion that for federal income tax purposes, including Subchapter S, Lemuel Woods was at all times the owner of the stock of Petitioner.

The Petitioner submits that no doctrine is more fundamental to the consistent, evenhanded and uniform administration of the federal tax laws than that of "substance prevails over form". By its decision, the Court of Claims ordains that this doctrine and the teachings of *Helvering v. Clifford, supra,* designed to disclose who is to be treated as the owner of trust assets for federal tax purposes, are to be laid aside in determining who is a shareholder of a Subchapter S corporation. The Petitioner respectfully submits that this position is palpably untenable and contrary to all authorities. *Fulk & Needham, Inc. v. United States,* 288 F.Supp. 39 (M.D.N.C. 1968), *aff'd,* 411 F.2d 1403 (4th Cir. 1969); *Old Virginia Brick Company v. Commissioner,* 367 F.2d 276 (4th Cir. 1966).

There is nothing in the language of the statute or the legislative history of Subchapter S which requires the abandonment of these principles. The issue presented in these proceedings was not addressed by the Congress at the time of the enactment of Subchapter S. Certainly, there is no indication in the legislative history that the provisions of Subchapter S are to be insulated from traditional federal tax principles and analysis.

**Inconsistent Treatment of Revocable Inter Vivos Trust**

The decision of the Court of Claims also introduces an inconsistency in the treatment of revocable inter vivos trusts under the Internal Revenue Code. To accord the Woods Trust treatment consistent with that accorded it for purposes of other provisions of the Internal Revenue Code, Lemuel Woods must be treated as the owner of the stock of Petitioner for Subchapter S purposes.

Under Subpart E of Subchapter J of the Internal Revenue Code (commonly referred to as the "grantor trust" rules), where a grantor such as Lemuel Woods retains the power to control the administration and beneficial enjoyment of assets placed in trust and to revoke the trust, the trust is not accorded



independent significance for federal income tax purposes. Instead, the grantor is treated as the owner of the assets comprising the trust. The Woods Trust was such a trust. Accordingly, pursuant to the grantor trust rules, Lemuel Woods is treated as the owner of the assets held by the Trust and taxable on the income derived therefrom.

Similar treatment obtains for purposes of Section 453(d) of the Internal Revenue Code. In that context, the question arises whether the transfer of an installment obligation by an individual to his trust constitutes a disposition of the installment obligation which would result under Section 453(d) in the immediate recognition of the gain or loss included in the unpaid balance of the obligation. Even though under state law the transfer constitutes a valid, enforcible transfer in trust, the Internal Revenue Service has ruled that such a transfer does not constitute a taxable Section 453(d) disposition. Rev. Rul. 74-613, 1974-2 C.B. 153. In this situation, the revocable inter vivos trust is again denied tax recognition independent of the grantor because, under the grantor trust rules, the grantor remains the owner of the trust assets for federal income tax purposes.

These same principles also apply in the estate tax area. Indeed, in Treasury Regulations, Section 20.2042-1(c)(6), relating to the estate taxation of corporate-owned life insurance on the life of a majority shareholder, the Internal Revenue Service uses the grantor trust rules as a sword to reach exactly the same result Petitioner urges herein. These Regulations provide that a decedent is considered to be the owner of stock held at the time of his death by any trust in respect of which the decedent is treated as the owner of the trust assets under the grantor trust rules.

In short, for other federal tax purposes, Lemuel Woods is treated as the owner of the stock in Petitioner held by the Woods Trust. As this Court has pointed out, it is essential that the Internal Revenue Code be interpreted so as to give a uniform application to the nation-wide system of taxation.

*Burnet v. Harmel*, 287 U.S. 103, 110 (1932). The Petitioner respectfully submits that the Court of Claims erred in according the Woods Trust different treatment for Subchapter S purposes than it receives for other purposes of the internal revenue laws.

**Decision Contrary to Other Decisions and Rulings**

The decision of the Court of Claims is also inconsistent with and contrary to analogous decisions of other courts and rulings of the Internal Revenue Service. For example, it has been held in all decisions on the subject that beneficial ownership rather than bare legal title is dispositive in determining who is a shareholder for purposes of Subchapter S. See, e.g. *Alfred N. Hoffman*, 47 T.C. 218 (1966), *aff'd*, 391 F.2d 930 (5th Cir. 1968); *Kean v. Commissioner*, 51 T.C. 337 (1968), *aff'd*, 469 F.2d 1183 (9th Cir. 1972); *William B. Wilson*, 34 T.C.M. 463 (1975); and *Lafayette Distributors, Inc. v. United States*, 397 F.Supp. 719 (W.D.La. 1975). The decision of the Court of Claims is clearly contrary to the holdings of these cases.

Likewise, the decision of the Court of Claims is irreconcilable with the many decisions holding that substance rather than form controls in determining who is a shareholder for Subchapter S purposes. See, e.g. *Fulk & Needham, Inc. v. U.S.*, 288 F.Supp. 39 (M.D.N.C. 1968), *aff'd*, 411 F.2d 1403 (4th Cir. 1969); *Old Virginia Brick Company v. Commissioner*, 367 F.2d 276 (4th Cir. 1966). The decision of the Court of Claims simply cannot be squared with the following pertinent language appearing in a footnote to the opinion of the Fourth Circuit Court of Appeals in *Fulk & Needham, Inc., supra:*

> "[Taxpayer] draws into question the validity of Treasury Regulation § 1.1371-1(a)(2) promulgated to implement § 1371(a)(2) of the statute. The Regulation purports broadly to disqualify any corporation in which a formal trust is a shareholder, regardless of the substance or nature of the trust. In particular, it provides that a corporation in which a voting trust or "Clifford" trust is a shareholder does not qualify under Subchapter S. Taxpayer points out that the



> Regulation was in part invalidated in *A & N Furniture Co. v. U.S.* [citations omitted] where the court held that a voting trust did not disqualify the electing corporation.
>
> *The portion of the Regulation condemned in that case [Regulation § 1.1371-1(e)] may well be open to challenge as conflicting with the principle of substance over form. Likewise, the portion of the Regulation which undertakes to disqualify a Clifford trust (where the form of a trust is employed but the grantor retains control and is taxed as the true owner) may be open to attack.*" 411 F.2d at 1407, ftn. 4 (emphasis supplied)

Despite the Court of Claims' attempts to distinguish them, the Petitioner submits that the decision is also inconsistent with and contrary to the analogous decisions in *A & N Furniture & Appliance Co. v. U.S.*, 271 F.Supp. 40 (S.D.Ohio 1967) and *Lafayette Distributors, Inc. v. U.S.*, 397 F.Supp. 719 (W.D.La. 1975), holding that a voting trust is not a shareholder other than an individual for Subchapter S purposes. No less than a revocable inter vivos trust, a voting trust is a valid trust under state law, according powers and duties to the trustee and establishing the trustee as the record holder of stock subject to the trust. Certainly it involves no more or less a nominee arrangement than that existing between a grantor and his revocable inter vivos trust.

In its administration of Subchapter S, the Internal Revenue Service itself has not relied on so superficial an interpretation of Section 1371(a)(2) as that adopted by the Court of Claims in its decision. Nowhere in the statutory language of Subchapter S is there express authority for a nominee, agent, guardian or custodian to be a qualifying shareholder of a Subchapter S corporation. Yet, the regulations make it clear that persons for whom stock in a Subchapter S corporation is held by any of these named representatives will be considered as shareholders of the corporations. Treasury Regulations, Section 1.1371-1(d)(1).

Additionally, the Internal Revenue Service acknowledges that for purposes of Section 1371(a), requiring that shareholders must consent to a Subchapter S election, beneficial ownership and not record ownership is determinative of who is a shareholder. Rev. Rul. 70-615, 1970-2 C.B. 169. Interestingly, in acknowledging the beneficial ownership test, the Internal Revenue Service spoke in terms of the entirety of Subchapter S, rather than simply the consent provisions:

> "Section 1.1371-1(d)(1) of the Income Tax Regulations provides, in part, that ordinarily the person who would have to include in gross income dividends distributed with respect to the stock of a small business corporation are considered to be the shareholders of the corporation.
>
> *Thus, for purposes of determining who is a shareholder under the provisions of Subchapter S of the Code, beneficial ownership of the stock rather than technical legal title is controlling."* 1970-2 C.B. at 169. (Emphasis supplied).

The Petitioner submits that the test for determining shareholder status cannot, as decided by the Court of Claims, be different for purposes of consecutive provisions of the Internal Revenue Code, integrated in both language and purpose.

It is respectfully submitted that the decision of the Court of Claims cannot be reconciled with the great body of authority concerning Subchapter S, including the administrative rulings and practices of the Internal Revenue Service. In short, the decision constitutes an unwarranted departure from analogous, well-reasoned and correct precedent.



## CONCLUSION

For these reasons, and because the decision of the Court of Claims sharply curtails the substantial benefits which Congress intended to accord small businessmen in the enactment of Subchapter S, the Petitioner respectfully submits that this Petition for a Writ of Certiorari should be granted.

s/s SHERWIN P. SIMMONS
SHERWIN P. SIMMONS

# APPENDIX

## APPENDIX A

# In the United States Court of Claims

No. 17-74

(Decided December 17, 1975)

---

**W & W FERTILIZER CORPORATION v. THE UNITED STATES**

---

*Sherwin P. Simmons*, attorney of record, for plaintiff. *Harold W. Mullis, Jr., Ronald S. Nauveen* and *Trenam, Simmons, Kemker, Scharf & Barkin*, of counsel.

*Charles E. Auslander, Jr.*, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Theodore D. Peyser* and *Donald H. Olson*, of counsel.

---

Before Cowen, *Chief Judge*, Laramore, *Senior Judge*, and Bennett, *Judge*.

---

ON DEFENDANT'S MOTION FOR SUMMARY JUDGMENT AND PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT

Laramore, *Senior Judge*, delivered the opinion of the court:

This is an action to recover Federal corporate income taxes paid by plaintiff, under protest, for the taxable year ended March 31, 1970. The sole question presented is whether the taxpayer's prior election to be treated as a "small business corporation" under Subchapter S of the Internal Revenue Code of 1954 [1] terminated when one of its shareholders transferred his stock to a revocable *inter vivos* trust.[2]

[1] All citations to sections hereinafter are, unless otherwise indicated, in reference to the Internal Revenue Code of 1954.

[2] Subchapter S (26 U.S.C. §§ 1371–1379), relieves an electing "small business corporation" of Federal corporate income tax liability (other than the tax imposed on certain capital gains by section 1378) for the period during which such election remains effective.

The relevant facts are as follows: Plaintiff, W&W Fertilizer Corporation (hereinafter referred to as "W&W" or as "taxpayer"), was incorporated under the laws of the State of Florida in 1907. In 1965 the company elected to be treated as a Subchapter S corporation, effective for its taxable year ended March 31, 1966, and subsequent years unless terminated. Immediately prior to February 25, 1970 (the date of the transfer to the trust), W&W had only two shareholders: Lemuel P. Woods, owning 47 percent of the company's stock, and Fred J. Woods, his brother, owning 53 percent. On the above date, Lemuel established the Lemuel P. Woods Revocable Trust (hereinafter referred to as the "Woods Trust") pursuant to a revocable trust agreement. Among the assets transferred to the trust on that date were all of the shares of W&W stock owned by Lemuel.

The Woods Trust was a revocable *inter vivos* or living trust, all of the income of which was taxable to and reported for Federal income tax purposes by Lemuel. As the grantor, Lemuel had reserved in himself the right to revoke at any time and to revest title to the trust's assets in himself, with the provision, however, that such right be exercised only in writing and after 90 days' notice to the trustee.[3] A bank was designated as co-trustee, along with Julia Woods, Lemuel's wife. Lemuel was sole income beneficiary for life, and at the time of the trust's inception, the remainder was variously divided among his wife and family.

Section 1372(e)(3)[4] of the Code provides that a Sub-

[3] Article eleven of the revocable trust agreement provided as follows: "Trustor reserves the right during his lifetime to alter, amend, modify or revoke this trust, or to withdraw assets from the trust estate or to require changes in the investments of the trust estate, and this right may be exercised at any time and from time to time by any instrument in writing signed by Trustor; provided, however, that Trustee may, at its option, require that it be given written notice at least ninety days prior to the effective date of any proposed alteration, amendment, modification or revocation of this trust or withdrawal of assets from the trust estate."

[4] "SEC. 1372. ELECTION BY SMALL BUSINESS CORPORATION. * * * (e) *Termination* * * *. (3) *Ceases to be small business corporation.* An election under subsection (a) made by a small business corporation shall terminate if at any time—(A) after the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or (B) after the day on which the election is made, if such election is made after such first day, the corporation ceases to be a small business corporation (as defined in section 1371(a)). Such termination shall be effective for the taxable year of the corporation in which the corporation ceases to be a small business corporation and for all succeeding taxable years of the corporation."



chapter S election is terminated at such time as a corporation ceases to be a "small business corporation" as defined in section 1371(a).[5] Subsection 2 of section 1371(a) specifies that a small business corporation may not "have as a shareholder a person (other than an estate) who is not an individual."

In light of sections 1371(a)(2) and 1372(e)(3), it is understandably not disputed that if during the taxable year ended March 31, 1970 taxpayer had as a shareholder a person who was not an individual, its Subchapter S election terminated. Both parties agree that a trust is not an individual within the meaning of section 1371(a)(2), and is, therefore, prohibited from becoming a Subchapter S shareholder. Hence, the resolution of this case turns on whether the revocable *inter vivos* trust described herein is to be accorded recognition for Federal tax purposes as a shareholder in taxpayer or, instead, whether the grantor-beneficiary is to be so recognized and the trust disregarded.

The government contends that when Lemuel transferred his shares to the Woods Trust, taxpayer's Subchapter S election terminated because, having a trust as a shareholder, it ceased to be a qualified "small business corporation" within the meaning of section 1371(a). Taxpayer, however, urges that "small business corporation" status continued even after the transfer because the Woods Trust should be disregarded, and Lemuel, the grantor, still accorded status as the owner.

In support of this, taxpayer makes three basic contentions. The first is that it is appropriate in this case to apply the well-settled rule that substance must govern over form. It is urged that because Lemuel retained *de facto* and *de jure* control over the trust *res*, in substance he, not the trust, must be regarded as the owner of the trust property. The second argument is that Lemuel never surrendered the beneficial interest in his W&W shares, and it is this interest that should control for purposes of deciding whether he remained

[5] "SEC. 1371. DEFINITIONS. (a) *Small Business Corporation.* For purposes of this subchapter, the term 'small business corporation' means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not—(1) have more than 10 shareholders; (2) have as a shareholder a person (other than an estate) who is not an individual; (3) have a nonresident alien as a shareholder; and (4) have more than one class of stock."

the shareholder within the contemplation of section 1371(a)(2). Finally, taxpayer urges that uniform application of certain Federal tax principles compel recognition of the grantor as the "tax" owner of the shares nominally held by the Woods Trust. Paramount among these principles is what is termed the "grantor trust rules," embodied in the Internal Revenue Code, which hold that a grantor of a trust who retains either administrative control, a reversionary interest, power to control beneficial enjoyment, or the power of revocation, will be taxed on the income derived from the assets of the trust. (Section 671, *et seq.*)

For reasons which follow, we reject all three points and hold instead that taxpayer's Subchapter S election terminated upon the transfer of the shares in question into the hands and ownership of the Woods Trust.

## I.

In its first contention, taxpayer cautions us against the exaltation of form over substance by reminding of the fact that Lemuel, as grantor of the trust, retained a quantum of economic control over the trust *res* by retaining the power to revoke. This power, along with his ability to influence the trustees' administrative decisions, is said, in economic substance, to make him the owner of the shares of taxpayer held by the Woods Trust.[6]

However, one of the persistent problems of income taxation, as of other branches of the law, is the extent to which legal consequences should turn on the economic substance of a transaction rather than on its form. It is easy to say that substance should control, but in practice form usually has some substantive consequence, so that if two transactions differ in form, they will probably not be identical as to substance. Congressional enactments of tax law often take note of this. To determine where the true substance of a particular enactment lies requires an inquiry into the reason for the passage of the law.

[6] While we reject taxpayer's first contention for other reasons set out below, we do note that Lemuel's economic control over the trust property was not plenary. Under the terms of the trust agreement the trustee could, at its option, require 90 days' written notice prior to the effective date of any proposed exercise of control by the grantor-beneficiary. See n. 3, *supra*.



Subchapter S was enacted to afford a qualified "small business corporation" the option of eliminating Federal income tax at the corporate level, thereby avoiding double taxation. S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958), (1958-3 Cum. Bull. 922, 1008). If a corporation qualifies, it pays no tax and its income is "passed through" to its shareholders. An examination of the legislative history of the Act reveals that Congress' motive for including qualification requirements was to insure both the efficacy of the law's remedial purpose and the avoidance of an extreme administrative burden otherwise falling on the government in applying the law. Congress, therefore, expressly incorporated a requirement of form into the Act by excepting certain types of business organization from the ambit of the law's effect.

More specifically, section 1371(a)(2) was intended to effectuate two congressional objectives. *Fulk & Needham, Inc.* v. *United States*, 411 F. 2d 1403 (4th Cir. 1969). First, it was designed to make the same tax treatment previously only available to proprietorships and partnerships also available to those small corporate business structures economically similar to proprietorships and partnerships. However, the similarity to partnerships and proprietorships was not complete under the congressional scheme. While partnership earnings may quite properly be passed through any type of business organization entitled by law to participate in a partnership, Congress expressly limited the availability of the special similar tax treatment to certain specified forms of business organization. The existence of a trust as a shareholder in a Subchapter S corporation would complicate the structure by adding another entity through which earnings would of necessity be passed. Congress anticipated this type of circumvention of the Act's objective by specifying qualification requirements of form for Subchapter S corporation shareholders.

The second, and equally compelling, reason for the adoption of the qualification requirement of section 1371(a)(2), was to avoid placing an enormous administrative burden on the government of tracing earnings to, and possibly through, a widely diversified and multitiered group of shareholders. If the Internal Revenue Service were required to verify and

monitor the identity of owners of artificial entities, themselves the owners of Subchapter S shares, the task would be monumental.[7] Such a possibility was obviated by specifically prohibiting persons "other than individuals" from owning Subchapter S stock.

In light of these two objectives, the impact of the qualification requirements upon the question of form and substance presented in this case was made abundantly clear in the Senate Committee Report, S. Rep. No. 1983, 85th Cong., 2d Sess. 217-218 (1958), (1958-3 Cum. Bull. 922, 1138-1139):

> Under section 1372(e)(3), an election terminates if the corporation ceases to be a small-business corporation. Thus, if an eleventh person or a nonresident alien becomes a shareholder in the corporation, *if a corporation, partnership, or trust becomes a shareholder*, or if another class of stock is issued by the corporation, *the election is terminated.* [Emphasis supplied.]

In our view, the above language spells clearly that the organizational form of the would-be shareholder constitutes the substance which must be examined when applying the qualification requirement contained in section 1371(a)(2).

The United States Court of Appeals, Fourth Circuit, has twice decided this same issue as applied to testamentary trusts. *Fulk & Needham, Inc.* v. *United States, supra; Old Virginia Brick Co.* v. *Commissioner*, 367 F. 2d 276 (4th Cir. 1966). In *Fulk*,[8] the taxpayer contended that the trust should be disregarded as lacking economic reality, because even if a

[7] For example, in 1970 over 250,000 corporations existed that had elected to be treated as Subchapter S corporations. Statistics of Income, 1970, Corporation Income Tax Returns, Treasury Department Publication 16, p. 1. If the Internal Revenue Service had to verify how many beneficiaries there were who, by disregarding their trust, were to be treated as shareholders, and to identify who the taxpayers actually were, such a procedure would amount to a very great burden. Further, tax planners could structure multitiered setups (for legitimate tax purposes) wherein it might be impossible to trace income and to identify taxpayers.

[8] A partner in a construction firm died and his share passed to a simple trust which was to pay the income to his wife for life, the trust to cease on her death and the corpus to pass to his daughters. After the testator's death, the partnership was incorporated and a portion of the shares of the new corporation were issued to the "Trustees of The A. P. Fulk Estate." The next year the estate was closed and the widow and daughters took the shares as co-trustees. Subsequently, the corporation filed an election for Subchapter S status which was determined to be invalid by the Internal Revenue Service.



trust existed under state law, it was not a trust in substance which should be recognized for purposes of Federal income taxation. It was further argued that since the beneficiary-trustee had been taxed on all income to the trust and treated the assets as her own, she, and not the trust, was the true "owner" of the shares. The court rejected this argument, stating at page 1406:

> The formula employed by Congress in § 1371(a)(2) in defining a small business corporation entitled to the benefits of subchapter S, speaks of a domestic corporation which does not have as a shareholder "a person (other than an estate) who is not an individual." By necessary implication a corporation in which a trust is a shareholder does not qualify.

The language of the Fourth Circuit quoted above is equally applicable to and determinative of the issue now before us. Lemuel chose to employ a revocable *inter vivos* trust in connection with his estate plan and the Woods Trust clearly has substance. Tax law simply does not permit a taxpayer to embrace such a device for one purpose and yet ignore it for tax purposes. *Cf. Commissioner* v. *Danielson*, 378 F. 2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967); *Dietzsch* v. *United States*, 204 Ct. Cl. 535, 498 F. 2d 1344 (1974). Indeed, the discovery by Lemuel that his chosen estate plan had an adverse effect on the tax status of his corporation appears to be precisely what the Supreme Court had in mind when, in *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974), it stated, at page 149:

> * * * while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, * * * [citations omitted] and may not enjoy the benefit of some other route he might have chosen to follow but did not.

Additionally, taxpayer's argument that the trust should be disregarded ignores the apparent principal purpose of its creation.[9] Lemuel had the right to income on taxpayer's stock

[9] We can only speculate as to the reason for creating the trust. The possibilities include facilitating the transfer of the title to the assets on Lemuel's death, avoiding probate and the expenses attendant thereto, and providing for management if Lemuel became incompetent.

prior to creating the trust, but the property would have been subject to probate and the possible delays and expenses attendant thereto. By creation of the trust, Lemuel retained the income from the stock (as before), but he created a new estate plan which would have considerable new consequences under Florida law upon his death. As well as asking us to ignore the testamentary consequences which follow from creation of the trust, taxpayer would have us ignore the fact that the trust took title to Lemuel's real property and securities, it paid his taxes, it made investments, it delivered title to securities and real property, and provided financing for at least one of his businesses.

The Supreme Court has rejected the proposition that a form of business organization once selected and employed for non-tax reasons may later be disregarded at tax time. *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422 (1949); *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943). This court has followed the tenor of these decisions. *Harrison Property Management Co., Inc.* v. *United States*, 201 Ct. Cl. 77, 475 F. 2d 623 (1973), *cert. denied*, 414 U.S. 1130 (1974); *Carver* v. *United States*, 188 Ct. Cl. 202, 412 F. 2d 233 (1969). The principles applied in these cases apply here as well. Whatever the reasons for creating the Woods Trust, it is a fact that the Woods Trust conducted business. Thus, having chosen to operate in this fashion, having enjoyed the advantages of this arrangement, neither Lemuel nor taxpayer can now avoid the tax consequences of Lemuel's choice and the separate identity of the Woods Trust. *Cf. Love* v. *United States*, 119 Ct. Cl. 384, 96 F. Supp. 919 (1951).

## II.

Taxpayer's second argument in support of its claim is that for purposes of determining who the shareholders are under the provisions of Subchapter S, beneficial ownership rather than legal title controls. Much is made of the cases and Revenue Ruling which look to beneficial ownership of Subchapter S stock in determining which party or parties are required to file the "consent" to election required by section 1372(a).[10] *William B. Wilson*, 34 T.C.M. 463 (1975); *Kean* v. *Commissioner*, 469 F. 2d 1183 (9th Cir. 1972); *Alfred N. Hoffman*, 47 T.C. 218 (1966), *aff'd sub nom. Hoffman* v. *Commissioner*, 391 F. 2d 930 (5th Cir. 1968); Rev. Rul. 70-615, 1970-2 Cum. Bull. 169. However, these authorities deal with stock hold by one as a nominee of another, rather than in trust as in the instant case.



The Treasury Regulations under Subchapter S recognize that under some circumstances the "record-owner" cannot be treated as an owner for Subchapter S purposes because he is not the real party in interest. Treasury Regulation, section 1.1371-1(d)(1) provides in part that:

> * * * Persons for whom a [sic] stock in a corporation is held by a nominee, agent, guardian, or custodian will generally be considered shareholders of the corporation.

This regulation quite correctly reflects that Congress did not intend to impose an individual income tax on the owners of shares of Subchapter S corporations without their consent. To have done so would have directly contravened the enactment's policy of elective tax treatment. Nor did Congress intend to vest in nominees, guardians, agents or custodians the power to defeat an election by withholding their consent. See Treasury Regulation, section 1.1371-1(d)(1).

But, from this we cannot deduce that a trust can either qualify as a shareholder under section 1371(a) or be disregarded as the shareholder, because trusts, unlike nominees, guardians, agents and custodians, are recognized for tax reporting purposes. This is significant because we believe section 1371(a) addresses only entities recognized as taxpayers by the Code. Nominees, guardians, agents and custodians are not recognized as taxable entities and, hence, cases cited by taxpayer in which courts have ignored them and looked instead to the real parties in interest for Subchapter S consent purposes, are inapposite to the case at bar where we deal with a trust. Notwithstanding the provisions of the Code which define, modify and even eliminate a trust's obligation to pay taxes, the trust does remain a taxable entity of the kind addressed in section 1371(a) and cannot be ignored

[10] Section 1372(a) provides that an election is valid only if all persons who are shareholders in an electing corporation consent to the election at a specified time.

for qualification purposes by looking through it to the beneficiaries.[11]

### III.

Taxpayer's third contention is that because Lemuel, as grantor of the Woods Trust, is taxed on the trust income under the "grantor trust rules" of section 671, *et seq.*, the trust should be ignored. The argument is that it would be inconsistent not to consider him the owner of the shares for Subchapter S eligibility purposes and yet tax him as their "owner" on the income they produce. Taxpayer, however, misconceives the manner in which the "grantor trust rules" operate. They do not, as taxpayer urges, recognize the grantor as the legal "owner" of the property placed in trust. On the contrary, the rules arose under the Code because it was recognized by Congress that taxation of income is not concerned so much with refinements of title as it is with actual command over the property taxed. *Corliss* v. *Bowers*, 281 U.S. 376 (1930). The "grantor trust rules" treat the grantor as if he were the owner in cases where he has reserved to himself some of the powers normally attendant to outright ownership. Thus, their design is to expand the coverage of the taxing statute. On the other hand, Subchapter S was enacted as a remedial measure to relieve qualifying small business corporations of a tax otherwise payable. Section

[11] We note here that in *A. & N. Furniture & Appliance Co.* v. *United States*, 271 F. Supp. 40 (S.D. Ohio 1967), a District Court held that subjecting shares of stock to a voting trust agreement did not terminate a Subchapter S election This decision is not inconsistent with our position here. In that case a proprietor formed a corporation with the shares being issued to himself and his family members. The corporation filed a valid election for Subchapter S status. Subsequently, all the shareholders subjected their stock to a voting trust agreement with the father as trustee for the stated purpose of insuring continuity and stability of policy and management. The court found that under state law the creation of the voting trust gave the trustee no interest in the shares subject to the trust, nor did it give him the power to transfer ownership of the stock by sale or otherwise. It gave him merely the power to vote the shares. Indeed, the stock transfer records of the company still showed the individual family members as the owners of the stock. In essence, the court held that the "voting trust" was not truly a trust, but was more in the nature of an irrevocable proxy; it was not ownership of the shares of stock which was involved, it was merely voting rights which were affected.

The same result was reached in *Lafayette Distributors, Inc.* v. *United States*, 397 F. Supp. 719 (W.D. La. 1975), the reasoning of which, in part, we today reject insofar as it might suggest, *inter alia*, the appropriateness of the "beneficial owner test" in determining who the shareholder is for purposes of section 1371(a)(2).



1371(a)(2) limits the benefits of the Act to corporations whose stock is owned solely by individuals or estates. Where such a deliberately specific qualification is imposed, we must strictly apply it lest the narrow benefit intended by Congress be unduly broadened. Hence, the "grantor trust rules," with the very purpose of expansion, and the qualification requirements of section 1371(a), with their restrictive purpose, are not analogous, and their comparison is not supportive of the taxpayer in this case.

Moreover, in making an argument based upon the applicability of the "grantor trust rules" taxpayer, in effect, concedes the existence and recognition of the Woods Trust for tax purposes because the rules themselves address taxation of trust income. If there were no trust for tax purposes, the rules would not apply. The applicability herein of the "grantor trust rules" embodied in section 671 *et seq.*, therefore, reinforces, rather than refutes, the argument that the Woods Trust must be recognized as the owner of taxpayer's stock.

### IV.

Finally, the government relies on Treasury Regulations, section 1.1371-1(e) and section 1.1372-4(b)(3), which provide:

> § 1.1371-1 *Definition of small business corporation.*
>
> * * * * *
>
> (e) *Shareholders must be individuals or estates.* A corporation in which any shareholders is a corporation, trust, or partnership does not qualify as a small business corporation. The word "trust" as used in this paragraph includes all trusts subject to the provisions of subchapter D, F, H, or J (including subpart E thereof), chapter 1 of the Code and voting trusts. Thus, even though the grantor is treated as the owner of all or any part of a trust, the corporation in which such trust is a shareholder does not meet the qualifications of a small business corporation.
>
> § 1.1372-4 *Termination of election.*
>
> * * * * *
>
> (b) *Methods of Termination.*
>
> * * * * *
>
> (3) *Ceases to be small business corporation.* An election under section 1372(a) terminates if at any time

> after the first day of the first taxable year of the corporation for which the election is effective, or after the day on which the election is made (if such day is later than the first day of the taxable year), the corporation ceases to be a small business corporation as defined in section 1371(a). Thus, the election is terminated if an eleventh person, a non-resident alien, or a trust, partnership, or corporation becomes a shareholder, or if another class of stock is issued by the corporation. * * *

In *Lykes Bros. Steamship Co., Inc.* v. *United States*, 206 Ct. Cl. 354, 369, 513 F. 2d 1342, 1350 (1975), and *Birchenough* v. *United States*, 187 Ct. Cl. 702, 710, 410 F. 2d 1247, 1252 (1969), we cited *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948), wherein the Supreme Court stated that it had:

> * * * many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons. *See, e.g.*, *Fawcus Machine Co.* v. *United States*, 282 U.S. 375, 378 [1931].

In light of what we have said in parts I, II and III of this opinion, it is our view that the above regulations correctly interpret Code section 1371(a)(2) to the extent that it prohibits an *inter vivos* revocable trust, such as the Woods Trust, from becoming a shareholder in a Subchapter S "small business corporation." In fact, section 1.1372-4(b)(3) precisely tracks the language of the Senate Committee Report on Subchapter S, quoted earlier, in stating "[t]hus, the election is terminated if * * * a trust becomes a shareholder * * *."

For the foregoing reasons, we are of the opinion that taxpayer is not entitled to recover. Therefore, defendant's motion for summary judgment is granted, and plaintiff's cross-motion for summary judgment is denied. The petition is dismissed.

U.S. GOVERNMENT PRINTING OFFICE: 1978



# APPENDIX B

## 26 U.S.C. 1371(a)

Sec. 1371. Definitions.

(a) Small business corporation.

For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not -

(1) have more than 10 shareholders;

(2) have as a shareholder a person (other than an estate) who is not an individual;

(3) have a nonresident alien as a shareholder; and

(4) have more than one class of stock.

## 26 CFR 1.1371-1(d)(1)

§ 1.1371-1 Definition of small business corporation.

(d) *Number of shareholders* - (1) *In general.* A corporation does not qualify as a small business corporation if it has more than 10 shareholders. Ordinarily, the persons who would have to include in gross income dividends distributed with respect to the stock of the corporation are considered to be the shareholders of the corporation. For example, if stock is owned by tenants in common, joint tenants, or tenants by the entirety, each tenant in common, joint tenant, or tenant by the entirety is generally considered a shareholder, but see subparagraph (2) of this paragraph relating to stock owned by husband and wife. Persons for whom a stock in a corporation is held by a nominee, agent, guardian, or custodian will generally be considered shareholders of the corporation. If stock is owned by a trust which is subject to the provisions of subchapters D, F, H, or J, chapter 1 of the Code, or by a voting trust, the trust is considered the shareholder even though the dividends paid to the trust are includible directly in the income of the grantor or some other person. If stock is owned by a partnership, such partnership and not its partners is considered to be the shareholder.

26 U.S.C. 1372(e) (3)

Sec. 1372. Election by small business corporation.

(e) Termination.

(3) Ceases to be small business corporation. An election under subsection (a) made by a small business corporation shall terminate if at any time -

(A) after the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day,

or

(B) after the day on which the election is made, if such election is made after such first day,

the corporation ceases to be a small business corporation (as defined in section 1371(a)). Such termination shall be effective for the taxable year of the corporation in which the corporation ceases to be a small business corporation and for all succeeding taxable years of the corporation.

26 CFR 1.1371-1(e)

§ 1.1371-1 Definition of small business corporation.

(e) *Shareholders must be individuals or estates.* A corporation in which any shareholder is a corporation, trust, or partnership does not qualify as a small business corporation. The word "trust" as used in this paragraph includes all trusts subject to the provisions of subchapter D, F, H, or J (including subpart E thereof), chapter 1 of the Code and voting trusts. Thus, even though the grantor is treated as the owner of all or any part of a trust, the corporation in which such trust is a shareholder does not meet the qualifications of a small business corporation.

26 CFR 1.1372-4(b) (3)

§ 1.1372-4 Termination of election.

(b) *Methods of termination* - (3) *Ceases to be small business*



*corporation*. An election under section 1372(a) terminates if at any time after the first day of the first taxable year of the corporation for which the election is effective; or after the day on which the election is made (if such day is later than the first day of the taxable year), the corporation ceases to be a small business corporation as defined in section 1371(a). Thus, the election is terminated if an 11th person, a nonresident alien, or a trust, partnership, or corporation becomes a shareholder, or if another class of stock is issued by the corporation. In the event of a termination under this subparagraph the corporation shall immediately notify the internal revenue officer with whom the election under section 1372(a) was filed. Such notification shall set forth the cause of the termination and the date thereof. In addition, if the termination was caused by the transfer of stock to an 11th shareholder, to a nonresident alien, or to a trust, partnership, or corporation, the notification shall specify the number of shares transferred to such person, the name of such person (or in the case of a trust the names of the trustees and beneficiaries), and the name of the shareholder who transferred such stock to such person. If the termination was caused by the issuance of a second class of stock, the notification shall indicate the number of shares of such new class issued and shall describe the differentiating characteristics of the new class of stock.